Internal Revenue Service
memorandum

TL-N-6632-89
CC:TL:TS/JROSENBERG

date: 02 AUG 1989

to: District Counsel, Brooklyn
Attn: Diane Mirabito

from: Assistant Chief Counsel, (Tax Litigation)

subject: [redacted]

This memorandum responds to your request for tax litigation advice dated May 11, 1989.

ISSUES

1. Whether [redacted], is liable for the section 6700 penalty when its only connection with the underlying tax shelter in the years in issue is the receipt of management fees from the corporate lessors, [redacted], and [redacted].

2. Whether the cost of book and software properties purchased by [redacted] and [redacted] and leased to the [redacted] partnerships should be deducted as a cost of goods sold in calculating the section 6700 penalty or whether such costs must be capitalized and recovered through depreciation and/or amortization deductions over the useful lives of the properties.

CONCLUSIONS

1. [redacted]'s receipt of management fees from both [redacted] and [redacted] and the close connection among all three entities through the actions of [redacted] is sufficient to support liability for the section 6700 penalty under the United Energy Corp. Court's "conspiracy" theory.

2. The acquisition costs of the properties acquired by [redacted] and [redacted] and leased to the [redacted] are capital costs which may be recovered through depreciation and/or amortization deductions over the useful lives of the properties. The costs are not deductible in the year incurred as cost of goods sold.

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FACTS

[redacted] ([redacted]) was formed on [redacted], having as its chief executive officer, [redacted]. [redacted] was the corporate lessor of book properties leased to [redacted] partnerships organized in [redacted].

[redacted] ([redacted]) is a wholly owned subsidiary of [redacted] and, again, [redacted] is its chief executive officer. [redacted] was the corporate lessor of the book properties leased to the [redacted] partnerships organized in [redacted], [redacted] of which were organized after [redacted].

[redacted] ([redacted]) was organized in [redacted] and is a wholly owned subsidiary of [redacted]. [redacted] is also the chief executive officer of [redacted] and its only employee. [redacted] is the corporate lessor of the book and computer software properties leased to the [redacted] partnerships organized in [redacted].

During the years in issue, [redacted] and [redacted] each acquired interests in book and software "properties" directly from various publishers. The interests acquired did not include any interest with respect to any copyright of the books or software. The book "properties" consisted of plates or negatives from which a book is printed. No information was contained in the administrative file concerning the software "properties" acquired. Consideration paid for the properties consists of a small cash down payment and long term notes, the terms of which required [redacted] and [redacted] to make principal and interest payments only as sales of the books and software produced from the "properties" are realized.

[redacted] and [redacted] each leased the book and software properties to the [redacted]. These partnerships were organized and promoted by officers or owners of [redacted] and [redacted]. The partnerships were comprised of investors seeking tax benefits (investment tax credit and partnership losses). Investment tax credit was passed through to the partnerships via an election under I.R.C. § 48(d) made by [redacted] and [redacted], and was computed based on an estimated fair market value for the leased "properties".

We have not been provided with the details of the acquisition of the properties by [redacted] and [redacted] or of the terms of the lease agreements for the properties between [redacted], [redacted] and the [redacted]. Some details of the arrangements between the parties are contained in program description materials provided to prospective purchasers for the [redacted] and [redacted] limited partnerships. Those details are described below.

[redacted] and [redacted] acquired the properties from various unrelated publishers for a fixed amount to be paid by way of a cash down payment plus notes. The terms of the notes apparently provide for payments of principal and interest to coincide with sales of the books and software by the partnerships (through distributors engaged by the partnership). The properties are leased to the [redacted] under an equipment lease calling for a guaranteed minimum rental based on a percentage of sales. Investment tax credit passed through to the partnerships by [redacted] and [redacted] was based on the fixed purchase price paid by [redacted] and [redacted] to the publishers.

The section 6700 penalty was asserted against [redacted] for the year [redacted] as a result of its receipt of management fees in the amount of $[redacted] from the corporate lessors, [redacted] and [redacted].

The 6700 penalty asserted against [redacted] was based upon [redacted]% of its income. The revenue agent determined that [redacted]'s gross income from its participation in the organization of [redacted] partnerships totaled $[redacted]. This amount was calculated from the total of fixed rents received in [redacted] and [redacted] (in the amount of $[redacted]) less the cash portion paid to the publishers for the book properties (in the amount of $[redacted]). Thus, the section 6700 penalty was asserted in the amount of $[redacted].

The amount of the penalty asserted against [redacted] was based upon the identical method. Again, the gross income was calculated from the total of fixed rents received in [redacted] and [redacted] ($[redacted]) less the cash portion paid to the publishers ($[redacted]), resulting in a gross income determination of $[redacted]. Accordingly, the section 6700 penalty was asserted in the amount of $[redacted].

By a letter dated [redacted], to Brooklyn District Counsel, the Department of Justice took the position that penalties asserted against [redacted] and [redacted] were calculated incorrectly. The Department of Justice believes that the book properties were capital items which should have been amortized over the term of the lease of the assets, rather than a deduction from gross receipts as a cost of goods sold.

DISCUSSION

Issue 1

The section 6700 penalty has been asserted against [redacted] for the [redacted] taxable year as a result of its receipt of management fees in the amount of $[redacted] from the corporate lessors [redacted] and [redacted]. Based on our review of the administrative files in this case, we are unable to determine exactly what activities [redacted] engaged in to earn the management fees. We recommend that the Department of Justice attempt to obtain additional information of exactly what [redacted] did to earn the $[redacted] in management fees from [redacted] and [redacted]. Management activities alone, unconnected with organization or sale of interests in the promotion, are probably not sufficient to fall within section 6700. The overlap in ownership between the entities involved and [redacted]'s control of those entities raises the possibility that management in this case may have involved organizational activities.

Moreover, it is the position of the Internal Revenue Service that one who organizes or participates in a sale of an abusive tax shelter does not have to directly or personally furnish a gross valuation overstatement or false statement to investors to be liable under section 6700. This policy is based upon the decision in United States v. United Energy Corp., 87-1 U.S.T.C. 9216 (N.D. Cal. 1987). In that case, defendant Delphine Lampert, wife of the promoter, signed her husband's name to, and personally furnished, "available for service" letters to investors knowing or having reason to know that they contained false statements; the Court found this to be conduct subject to the section 6700 penalty. Mrs. Lampert was the sole stockholder of the corporation and an officer, director and incorporator of United Energy Corp. The Court found, as a finding of fact, that Mrs. Lampert assisted her husband in the operation of the corporation and was, or had reason to be, aware of the state of the solar farms and the installation of the modules which were not functional. In addition, the Court found that "All four defendants organized and assisted in the organization of an investment plan or arrangement and participated in the sale of interests in the plan or arrangement," and " ... UEC's operations were not conducted with the reasonable expectation of producing a viable enterprise."

As one of its conclusions of law, the United Energy Corp. Court found that "The phrase a 'statement with respect to' in § 6700(2)(A) refers to false statements of facts that are relevant to a taxpayer's decision to claim tax credits, deductions or benefits." Further, the Court found that "Mrs. Lampert entered into an implicit agreement with her husband to participate in conduct which the court finds violative of section 6700."

The District Court also declined to follow the decision reached in United States v. Turner, 601 F. Supp. 757 (E.D. Wis. 1985), aff'd, 787 F.2d 595 (7th Cir. 1986). The United Energy Corp. Court concluded that it:

> would frustrate the congressional purpose if a person who funded an enterprise, acted as one of its officers and directors, and profited from it, could insulate him or herself merely by employing salespeople who actually

> made the false statements. Rather, the law of conspiracy should apply in this situation. Thus, where, as here, two or more people implicitly agree to participate in conduct found to be unlawful each conspirator should be found liable for the acts of the co-conspirators.

The Internal Revenue Service also does not follow the Turner decision.

It is our position that any motion for partial summary judgment regarding [redacted]'s liability for the section 6700 penalty should be defended based upon the United Energy Corp. decision. [redacted]'s chief executive officer, [redacted], is also the CEO for [redacted] (hereinafter "[redacted]") and [redacted] (hereinafter "[redacted]"). Further, [redacted] is a wholly owned subsidiary of [redacted], while [redacted] is a wholly owned subsidiary of [redacted]. [redacted] is owned by a trust for the benefit of [redacted]'s children, with [redacted] acting as the trustee. [redacted]'s only employee in [redacted] was [redacted] and [redacted] had no employees at all. We believe that [redacted]'s receipt of management fees from both [redacted] and [redacted] and the close connection among all three entities through the actions of [redacted] is sufficient to support liability for the section 6700 penalty under the United Energy Corp. Court's "conspiracy" theory.

Issue 2

I.R.C. § 263 provides that no deduction shall be allowed for permanent improvements of betterments made to increase the value of capital expenditures to which section 263 relates. In [redacted], the year in which [redacted] and [redacted] acquired the properties, Treas. Reg. § 1.263(a)(2) provided, by way of example, that the cost of acquiring equipment and similar property having a useful life which extends beyond the taxable year of acquisition is a capital expenditure which is not deductible in the year of acquisition. these costs are recoverable through depreciation deductions under section 168 for tangible personal property and under section 167 for intangible property. From the facts provided above, we are unsure whether the "properties" [redacted] and [redacted] acquired from the publishers consisted merely of plates and negatives or included separately bargained for intangible rights (such as a license) to exploit the plates and negatives. Under either scenario, the costs of acquisition would be recovered over the useful life of the "properties."

Because the properties were leased to the [redacted], the income earned by [redacted] and [redacted] constitutes rental income for which there is no cost of goods sold deduction in arriving at gross income. The cost of goods sold deduction used to compute gross income is applicable only to income derived from sales of property, manufacturing, merchandising and mining. See Treas. Reg. §§ 1.61-6 and 1.61-3. By comparison, gross income from rental activities is comprised of the amount of rent realized, unreduced by the cost basis of the property transferred. See Treas. Reg. § 1.61-8. Neither [redacted] nor [redacted] derived income from the sale of property, manufacturing, merchandising or mining during the years in issue. Accordingly, the acquisition costs of the properties would not be currently deductible as cost of goods sold in arriving at gross income and [redacted]'s and [redacted]'s activities for those years.

Based on the facts presented, we conclude that the acquisition costs of the properties must be capitalized and recovered through depreciation and/or amortization deductions over the useful lives of the property. Since amortization or depreciation deductions are deductions from gross income, the section 6700 penalties should be calculated on the total rents received by these companies (which constitutes their gross income) without a reduction.

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